No. 11,688

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

THOMAS H. BRODHEAD, doing business as T. H. Brodhead Co.,
Appellant,

vs.

WILLIAM BORTHWICK, Tax Commissioner and Tax Collector of the Territory of Hawaii,
Appellee.

Upon Appeal from the Supreme Court for the Territory of Hawaii.

REPLY BRIEF FOR APPELLANT.

URBAN E. WILD,
MILTON CADES,
Bishop Trust Building, Honolulu, T. H.,
Attorneys for Appellant.

SMITH, WILD, BEEBE & CADES,
Bishop Trust Building, Honolulu, T. H.,
Of Counsel.

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ARGUMENT.

A. THE TERRITORY OF HAWAII CANNOT LAWFULLY IMPOSE A TAX ON THE GROSS RECEIPTS FROM SALES TO THE UNITED STATES OR ITS AGENCIES OR INSTRUMENTALITIES.

1. The Territory of Hawaii is not a sovereign government with inherent power to impose taxes, but derives its power to tax from the United States.

2. Congress has never delegated to the Territory of Hawaii power to tax the United States or its agencies or instrumentalities.

Appellee contends that the Territory of Hawaii was created as a sovereign government with full power to

impose taxes and that the Territorial power to tax the United States and its agencies and instrumentalities is as great as and no greater than the powers of the states with respect to such taxation. *Kawananakoa v. Polyblank,*[1] which is cited as holding that the Territory of Hawaii was created by Congress as a sovereign government, falls far short of such holding. It merely holds that the doctrine that a sovereign is exempt from suit was applicable in a mortgage foreclosure suit against the Territory of Hawaii on the ground that the doctrine is not confined to powers that are sovereign in the full sense of juridical theory, but naturally is extended to those that in actual administration originate and change at will the laws of contract and property from which persons within its jurisdiction derive their rights. Since the Organic Act placed the classification and control of the body of private rights in the Legislature of the Territory of Hawaii, the fountainhead from which such rights flow is the Territory and, consequently, as between it and its citizens, the Territory is supreme.

In support of the claim that the Territory has the full taxing power which Congress, itself, could have exercised, the Appellee cites *Yerian v. Territory of Hawaii,*[2] *Rivera v. Buscaglia,*[3] and *Haavik v. Alaska Packers Asso.*[4]

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[1]205 U.S. 349, 51 L. ed. 834 (1907).
[2]130 F.2d 786 (C.C.A. 9, 1942).
[3]146 F.2d 461 (C.C.A. 1, 1944).
[4]263 U.S. 510, 68 L. ed. 414 (1924).

In the *Yerian*[2] case, *supra,* there was involved not a tax on the United States or its agencies or instrumentalities, but a tax on the compensation of employees of instrumentalities of the United States which the court held were not exempted from the tax and could have been taxed even if Congress had not consented. Actually, however, Congress has consented to the taxation of such salaries under Section 4 of the *Public Salaries Tax Act of 1939,*[5] provided that there is no discrimination against such employees because of the source of their compensation. In *Rivera v. Buscaglia,*[6] *supra,* the court stated that the question of whether Puerto Rico may tax the salaries of a certain employee of the federal government depends upon whether Congress has given consent, which is distinct from the question of reciprocal immunity from tax as between the federal government and the states of a union to be derived from the general scheme of the Constitution of the United States. The court analysed the history of the taxing Act and found that there was an implication that Congress intended to include the salaries of federal employees as subject to tax, and in any event held that consent had been specifically given to the tax under the *Public Salaries Tax Act of 1939,*[7] *supra.*

The *Haavik*[8] case, *supra,* in holding that Alaska was given the right to tax to the full extent that Congress could, did not go so far as to give the territory the

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[5](5 U.S.C.A., Section 84(a)).
[6]146 F.2d 461 (C.C.A. 1, 1944).
[7](5 U.S.C.A., Section 84(a)).
[8]263 U.S. 510, 68 L. ed. 414 (1924).

right to tax the United States or agencies or instrumentalities of the United States without its express consent.

The Congress has never delegated to the Territory of Hawaii power to tax the United States or its agencies or instrumentalities. *Domenech v. National City Bank,*[9] *Posadas v. National City Bank,*[10] *Puerto Rico v. Shell Co.,*[11] *Yerian v. Territory of Hawaii,*[12] *supra.*

The statement of this Court in the *Yerian*[12] case, *supra,* does not go as far as Appellee's statement "* * * that the overruling of the doctrine of the tax immunity of those dealing with the federal government is as effective in the Territory of Hawaii as elsewhere."[13] A continuation of the quotation of Appellee would go on to this Court's statement that a territory cannot any more than a state tax the federal government or its agencies or instrumentalities without the consent of Congress. Summarized, the conclusion would seem to be that neither a state nor a territory can tax the United States or instrumentalities thereof; that a state, by reason of its inherent sovereignty is limited by construction of the Constitution so that it cannot interfere with the activities of the United States in the exercise of its sovereign rights; that because of the necessity for the two sovereigns to coexist together, a certain leeway is permitted the

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[9]294 U.S. 199, 79 L. ed. 857, 861 (1935).
[10]296 U.S. 497, 80 L. ed. 351, 354 (1936).
[11]302 U.S. 253, 82 L. ed. 235, 247 (1937).
[12]130 F.2d 786 (C.C.A. 9, 1942).
[13]Brief for Appellee, p. 11.

state although some economic burden may fall on the federal government.

In the case of a territory, however, the territory may only burden the activities of the federal government to the extent provided by Congress itself, and there is not the same reason for permitting the burdening of the federal government by a territory as exists in the case of a state.

The *Yerian*[14] case, supra, was intended to go no further than *Talbott v. Silver Bow County Commissioners*[15] which construed a consent by Congress for states to tax national banks to include territories on the ground that the statute meant to include organized political societies with established governments, and not merely state as that term is used in the Constitution. The *Yerian*[14] case, *supra,* does not go to the length of placing states and territories on the same basis in so far as their respective powers to impose taxes that may burden the United States are concerned. It should be noted that in the *Yerian*[16] case, *supra,* this Court stated that there was not involved a tax on an instrumentality of the United States, but merely a tax on the compensation of employees of the United States. Appellee makes the point,[17] which was conceded, that Congress may, by specific grant, give to territories taxing power denied to a state, and cites in support thereof *Inter-Island Steam Nav. Co. v.*

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[14]130 F.2d 786 (C.C.A. 9, 1942).
[15]139 U.S. 438, 35 L. ed. 210 (1891).
[16]130 F.2d 786 (C.C.A. 9, 1942).
[17]Brief for Appellee, footnote p. 11.

Hawaii,[18] and *Buscaglia v. Ballester.*[19] These cases make clear the validity of Appellant's contention that the taxing power of the Territory is altogether different from the taxing powers of a state, being derived from Congress.

As between the United States and the creature it creates, there is no question but that the tax or the burden on the sovereign is only that which the sovereign permits. In the case of a state, the taxing power is inherent because the state is a sovereign power limited only by what has been granted to the federal government by the Constitution. A state tax, subject to certain limitations, may impose a burden on the federal government, but still, because of the necessity of the two sovereign powers coexisting together under our constitutional system, such a tax is tolerated.

Appellee cites[20] a number of reasons which it claims overcome the contention in the opening brief[21] to the effect that the Organic Act is to be interpreted in the right of its meaning and intent when Congress adopted it. It is our contention that the argument of Appellee in this regard is specious.

It should be noted that in the *Yerian*[22] case, *supra,* and *Rivera v. Buscaglia,*[23] *supra,* Congress has consented to the taxes there in question; that although the

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[18]305 U.S. 306, 83 L. ed. 189 (1938).
[19]162 F.2d 805 (C.C.A. 1, 1947).
[20]Brief for Appellee, pp. 12 to 14, incl.
[21]Opening brief, pp. 23 to 25, incl., and 27.
[22]130 F.2d 786 (C.C.A. 9, 1942).
[23]146 F.2d 461 (C.C.A. 1, 1944).

Panhandle Oil Co. v. Mississippi ex rel. Knox[24] case was decided in 1928, the doctrine on which it was bottomed did not originate in 1928, but went back to *McCulloch v. The State of Maryland, et al.;*[25] that there is no parallel between the grant of taxing power by a state to a municipality and a grant of taxing power by Congress to a territory. All the state tax cases cited go to the construction by the states of their own Acts, If, by reason of a changed construction of an Act it is judicially determined that a municipality has power to tax although previously it had been held otherwise, such power to tax as so determined has always existed subject to the state courts' own determination of whether the statute or the ordinance or the constitution intended the tax power to be delegated. In the case of the Territory, it becomes a question of what the power of the Territory itself was, in which case it is necessary to go back to the intent of Congress in the enactment of the Organic Act from which the Territory derives its power. It is Appellant's contention that, by reason of the inherent difference in the fundamental nature of states and territories, the cases relating to the immunity of the federal government from taxation by the states are not authority in interpreting the immunity of the federal government from taxation or the imposition of burdens by the Territory.

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[24]277 U.S. 218, 72 L. ed. 857 (1928).
[25]17 U.S. (Wheat. 4) 316, 4 L. ed. 579 (1819).

3. **A statute which includes the gross receipts from sales to the United States and its agencies and instrumentalities, within the measure of the tax, is a tax on the United States.**

4. **The Panhandle[26] case, supra, has not been overruled in so far as the holding that a tax on sales to the United States is unconstitutional.**

The case of *Wilson v. Cook*[27] is said to put at rest the remaining doubt as to the *Panhandle*[26] line of cases having been overruled.[28] This case did not involve a sale to the United States, but involved a contract for the purchase and severance of timber on national forest reserves. As stated by Appellee,[29] the court held that the Supreme Court of Arkansas was right in holding, "* * * that plaintiffs, who are taxed by the state on *their activities in severing lumber from Government lands*[30] under contract with the Government, cannot claim the benefit of the implied constitutional immunity of the Federal Government from taxation by the state."[31] Obviously this was a tax on activities of the plaintiffs under a contract with the United States which the court held was not a tax upon the government. Again, this is another case in which the claim to immunity depends on the claimed economic burden on the United States, which, while more direct than in the *James v. Dravo Contracting Co.*[32] and *Alabama v. King & Boozer*[33] cases, is still not as direct

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[26]277 U.S. 218, 72 L. ed. 857 (1928).
[27]327 U.S. 474, 90 L. ed. 793 (1946).
[28]Brief for Appellee, p. 19.
[29]Brief for Appellee, p. 20.
[30]Emphasis supplied.
[31]327 U.S. 474, 483, 90 L. ed. 793, 800.
[32]302 U.S. 134, 82 L. ed. 155 (1937).
[33]314 U.S. 1, 86 L. ed. 3 (1941).

as in the case of sales to the United States here in question.

With respect to the cases cited by Appellee on which Appellee relies,[34] it should be noted that none of the federal cases cited relate to sales to the United States. *James v. Dravo Contracting Co.*,[35] *supra,* involved a tax on a contractor of the proceeds of his contract with the United States. *Western Lithograph Co. v. State Board of Equalization*[36] was based on the holding of the California court, at page 737, that the tax is not on the sale, but, rather, is a tax in the same category as property and excise taxes payable by an independent contractor engaged in the business of retail sales. It is a tax computed on the gross receipts from the conduct of the business of the retail merchant. The effect of this holding was substantially nullified in *Richfield Oil Corp. v. State Board of Eq.*[37] where the Supreme Court held that the designation of the tax was immaterial and that the real effect of the tax must be looked into.

The *Federal Land Bank of St. Paul v. De Rochford*[38] case states (without the benefit of Supreme Court approval) that the *Panhandle*[39] case, *supra,* has been overruled.

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[34]Brief for Appellee, pp. 22 to 27, incl.
[35]302 U.S. 134, 82 L. ed. 155 (1937).
[36]78 P.2d 731, 737 (1938).
[37]329 U.S. 69, 91 L. ed. (Adv. Sheets) 123 (1946).
[38]287 N.W. 522 (1939).
[39]277 U.S. 218, 72 L. ed. 857 (1928).

Compress of Union v. Stone[40] involved a tax on the proceeds of services where sales to the United States were specifically exempted under the statute and, obviously, has no application.

United States v. Lee[41] is similar to *Western Lithograph,*[36] *supra,* and its effect is nullified by the *Richfield Oil*[37] case, *supra.*

Smith v. Davis[42] relates to an *ad valorem* tax which would seem to be irrelevant.

Carnegie-Illinois Steel Corporation v. Alderson[43] involved not sales to the United States, but, rather, a lump-sum contract for the manufacture of armor plate and deck plate used in the construction of warships, and is no different than the *Dravo*[44] case, *supra.*

Reconstruction Finance Corp. v. Beaver County[45] seems to lend no light to the questions in issue.

Sanders v. Oklahoma Tax Commission[46] is no different than the *King & Boozer*[47] case, *supra.*

Salt Lake County v. Kennecott Copper Corporation[48] involved an *ad valorem* tax and seems to have no application to the present case.

In addition, it should be noted that it is only if the tax is nondiscriminatory in so far as the federal

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[40]193 So. 329 (1940).
[41]13 So.2d 919 (1943).
[42]323 U.S. 111, 89 L. ed. 107 (1944).
[43]34 S.E.2d 737 (1945).
[44]302 U.S. 134, 82 L. ed. 155 (1937).
[45]328 U.S. 204, 90 L. ed. 851 (1946).
[46]169 P.2d 748 (1946).
[47]314 U.S. 1, 86 L. ed. 3 (1941).
[48]163 F.2d 484 (C.C.A. 10, 1947).

government or its agencies are concerned that it may be, in any event, sustained.[49] If, for the reasons set forth in Section B hereof, it is held that the tax imposed by the Statute in question discriminates against the United States, then the act is unconstitutional *in toto*.

B. THE TERRITORY OF HAWAII CANNOT LAWFULLY IMPOSE A TAX AT A HIGHER RATE WITH RESPECT TO SALES TO POST EXCHANGES THAN WITH RESPECT TO SALES TO OTHER RETAIL MERCHANTS FOR RESALE.

There is nothing in the Statute to support the interpretation of the Supreme Court of the Territory of Hawaii that the statute makes any classification based on whether or not a second taxable activity occurs. As a matter of fact, under the scheme of the statute, it is quite reasonable to suppose, and it is possible that as many as four or five taxes may be laid upon sales of the same goods. The vice of the determination of the Supreme Court is that it has attempted to classify all activities of the federal government in the same class, regardless of the purpose for which various agencies of the United States may purchase the goods, the sale of which is subject to tax, and in effect did classify the government as "all other purchasers" regardless of whether the purchases were for resale or not.

The evidence of the Deputy Tax Commissioner in charge of gross income taxation is completely disre-

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[49]Opening brief, p. 43.

garded and the prior history of the collection of the tax is altogether omitted from the consideration of the court.

As testified by Mr. Westly, prior to January 1, 1942, the only tax on sales to the United States which the Territory sought to collect from the Statute were those to the post exchanges and ships' service stores at ¼ of 1%.[50] Beginning January 1, 1942, the tax on sales to post exchanges was increased to 1½%, and all sales to the United States were taxed at the same rate. The increase in tax was made because it was determined that post exchanges were not required to have a license because they were instrumentalities of the United States.[51]

From the evidence it was apparent that, as construed by the Tax Commissioner, post exchanges were originally treated as retail merchants purchasing for purposes of resale and, when it was to the advantage of the Territory, a wholesale tax was collected from sellers to post exchanges at a time when all other sales to the United States were deemed to be exempt from tax. When it was determined, at least to the satisfaction of the Territory, that the Territory could tax sales to the United States, it chose not to distinguish the two kinds of sales, but to treat all sales to the United States as subject to tax, although it had always recognized sales to post exchanges as being properly taxable at the wholesale rate.

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[50]R. 155-6.
[51]R. 160-1.

The question is asked in Appellee's brief whether the Territory can, in a privilege tax act which taxes every sale, service or other activity, avoid the undue pyramiding of the tax by prescribing a lower rate where a second taxable activity is to follow, and, if it does, must it segregate and give consideration to an activity of the United States which, for taxation purposes, it is required to disregard.[52] While there cannot be much question that the avoidance of undue pyramiding of a tax is a valid purpose of classification, as stated above, that is not the purpose of the Act nor is it in any way accomplished by the Act. The same Legislature which enacted the tax Act here in question enacted a Use and/or Consumption Tax Act[53] under which there was exempted sales which were subject to tax under the Gross Income Tax Act. The language of that Act is plain and clear, and it seems unreasonable to suppose that the Legislature, if it had intended to exempt or give a lower rate of tax to sales previously taxed, could have stated its intention in clear and plain language.

In the General Excise Tax Act itself there are several provisions which indicate that the Legislature knew how to state an exemption or how to prevent double taxation if that was its purpose.[54] The absence of such language in the Act clearly indicates that there was no intention to prevent a so-called "pyramiding of tax." On the other hand, it is much more reason-

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[52]Brief for Appellee, p. 35.

[53]Act 160, Session Laws of Hawaii, 1935.

[54]See, for example, Brief for Appellee, App. Sec. 2, C(2), D(2), pp. 12, 14, incl.

able to suppose that the Legislature classified wholesalers as such and imposed a smaller tax with regard to their sales because wholesalers generally deal in larger quantities and have a greater volume of sales with a smaller mark-up and thus are not able to pay as high a tax as retailers whose mark-up is higher and whose turnover is much smaller.

The Appellee contends[55] that the Supreme Court balanced the 1½% tax paid upon sales to the United States, the ¼ of 1% on the sale to licensed merchants, plus the 1½% added before the goods reached the consumer, and found a fair balance. The actual fact, however, is that this tax, collected from the seller on sales to the post exchanges, was collected at the higher rate because it was determined that the Territory could not collect on account of the sales of the post exchanges.

In an opinion of the Attorney General to Honorable William Borthwick, January 8, 1945,[56] it was stated that since the Statute does not make any difference in a service business because of the intrusion of a middle-man, certain transactions were taxable at the retail rate; that it was only in sales that different rates were applicable. In the opinion there is no suggestion of any purpose of the law to prevent pyramiding, although each of the cases cited were cases in which relief should have been accorded if the statute had any such intention. For example, there was in question the case of a customer bringing a film to

[55]Brief for Appellee, p. 37.
[56]Hawaii Tax Service, P-H, Par. 23042.

a drugstore to have prints made therefrom. The drugstore sends the film to Kodak Hawaii to have the prints made. Kodak Hawaii makes the prints and sells them at wholesale prices to the drugstore which, in turn, resells them to the customer at retail prices. Held that Kodak Hawaii must pay a retail tax as must the drugstore. Another case[57] is where a customer requests a drugstore to develop a roll of film and make a clear negative. Kodak Hawaii does the work, charging wholesale prices, and, on resale, the drugstore makes a retail charge. Held both Kodak Hawaii and the drugstore are subject to tax at the retail rate.

The argument of Appellee, based on a composite tax structure to prove that the United States has suffered no harm by reason of the tax imposed on account of sales to post exchanges at reduced rates, is pure fancy. The case of *Tradesmens Nat. Bank v. Oklahoma Tax Com.*[58] in no way sanctions a so-called "composite tax structure". There, the court merely examined the practical question of whether a national bank was being discriminated against under an act of Congress which expressly permitted states to tax national banks at a rate no higher than other businesses. Under the express consent granted, it was necessary to determine whether, under different types of taxes, there was any discrimination against the national bank. In arguing that in the Territory of

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[57]Included in the same opinion (Hawaii Tax Service, P-H, Par. 23042).

[58]309 U.S. 560, 84 L. ed. 947 (1940).

Hawaii the same procedure was followed, it is contended that there was a total of 1½% added before goods reached the consumer through taxation of the sale to post exchanges, as against 1¾% where goods reached the consumer through other retail sources, Appellee attempts to make the composite tax structure the yardstick.

Such a test is, of course, one based upon indirect economic burden upon the United States, and is not a proper test in determining whether there has been discrimination against the United States or not. The true test of discrimination is a practical one, as set forth on pp. 56 to 59, inclusive, in the opening brief.

Wilson v. Cook,[59] *supra,* which is stated[60] to afford a decisive answer to Appellant's claim of discrimination, did not answer the question of discrimination at all. In the majority opinion, the court said that it was not determining, because it was not called on to determine "* * * whether plaintiffs could have successfully contested their liability in the state courts or here, if the contentions were properly raised, upon the ground that they would be unable to collect the tax from the Government, *either*[61] because the provision purporting to allow such collection is inapplicable where the owner is the Government *or*[61] if applicable, invalid, *or*[61] on the ground that the tax, applied to them without recourse against the Govern-

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[59]327 U.S. 474, 90 L. ed. 793 (1946).
[60]Brief for Appellee, p. 39.
[61]Emphasis supplied.

ment, would deny to them the equal protection of the laws.''[62]

The reference to the holding of the majority of the court that any claim of discrimination ''* * * would lie under the equal protection clause, not the federal immunity doctrine * * *'',[63] is not borne out by the language of the court referred to above. The court pointed out, as noted above, that there were three alternative contentions that might have been made by the plaintiffs which were not made, and that, therefore, it did not pass on the question of discrimination. Further, in the dissenting opinion, it was stated that to treat the tax as applicable to the severer, and to treat the collection provisions from the government as inapplicable, would raise serious questions of discrimination which neither the state court nor *this court* has considered. Because the issue of discrimination was not raised since the plaintiffs had no way of knowing that the court, in its determination, would so construe the Act to make such a contention necessary, the dissenting Justice was of the opinion that the case should be remanded for a determination on the matter of the applicability of the collection provisions from the United States.

In so far as the *Kaiser Co. v. Reid*[64] and *S.R.A. Inc. v. Minnesota*[65] cases are cited with regard to discrimination, there seems to be no application to

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[62]327 U.S. 474, 485, 90 L. ed. 793.
[63]Brief for Appellee, p. 40.
[64]184 P.2d 879 (1947).
[65]327 U.S. 558, 90 L. ed. 851 (1946).

the present case; the *Kaiser*[64] case, *supra,* being one of economic burden, and the *S.R.A.*[65] case, *supra,* involving an *ad valorem* property tax where, again, mere economic burden is involved.

The Appellee[66] states that the contention is that post exchanges are in competition with retail merchants for business.[67] This is an incorrect statement of the contention of the Appellant. The competition that is spoken of is on the right to purchase. The whole line of argument, in connection with the alleged factual discrimination, of the Appellee is false because it is based on a misconception of the argument of the Appellant, which is fully set forth in the opening brief.

CONCLUSION.

It is, therefore, respectfully submitted that:

I. The Territory of Hawaii cannot lawfully impose a tax on the gross receipts from sales to the United States or its agencies or instrumentalities.

(a) There is no proper analogy between the right of states and the right of territories to impose taxes on the United States or its agencies or instrumentalities, or their respective rights to impose burdens upon federal activities.

(b) In any event, it has not been finally held by the Supreme Court of the United States that a state may tax sales to the United States.

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[66]Brief for Appellee, pp. 46, 47.
[67]Opening brief, p. 56.

II. The Territory of Hawaii cannot lawfully impose a tax at a higher rate with respect to sales to post exchanges than with respect to sellers to other retail merchants for resale.

(a) In determining whether a classification is proper, two separate taxes imposed on different taxpayers on account of different transactions cannot be considered together.

(b) The test of discrimination is a practical one, and it has been shown that the federal government is hindered in the purchase of merchandise in the Territory of Hawaii by reason of the higher tax upon sales to post exchanges than on sales to other persons for resale.

Dated, Honolulu, T. H.,
August 20, 1948.

URBAN E. WILD,
MILTON CADES,
By URBAN E. WILD,
His Attorney-in-Fact,
Attorneys for Appellant.

SMITH, WILD, BEEBE & CADES,
Of Counsel.